# Islamic Banking in Pakistan

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The first phase of Islamic banking in Pakistan during the 1980s under the patronage of Zia-ul-Haq was not successful. However, with increased participation of Shari'ah scholars in the policy making, product design, audit and supervision, the second phase has seen impressive and consistent growth since 2002. Now, Islamic banking in Pakistan is an established industry with 10% market share achieved in just over a decade. There are 5 full fledged Islamic banks and 18 other commercial banks that operate Islamic banking windows alongside conventional banking in Pakistan.

The basic structure of Islamic banking can be explained as follows. First, an Islamic bank creates an asset pool which consists of bank's equity and deposits. Deposits include two further classifications, i.e. remunerative deposits and non-remunerative deposits. Remunerative deposits are mobilized using partnership mode 'Mudarabah' with bank's shareholders and depositors as partners. Profit sharing ratio is agreed at the start of this partnership. Non-remunerative deposits are mobilized using Qarz (non-compensatory loan).

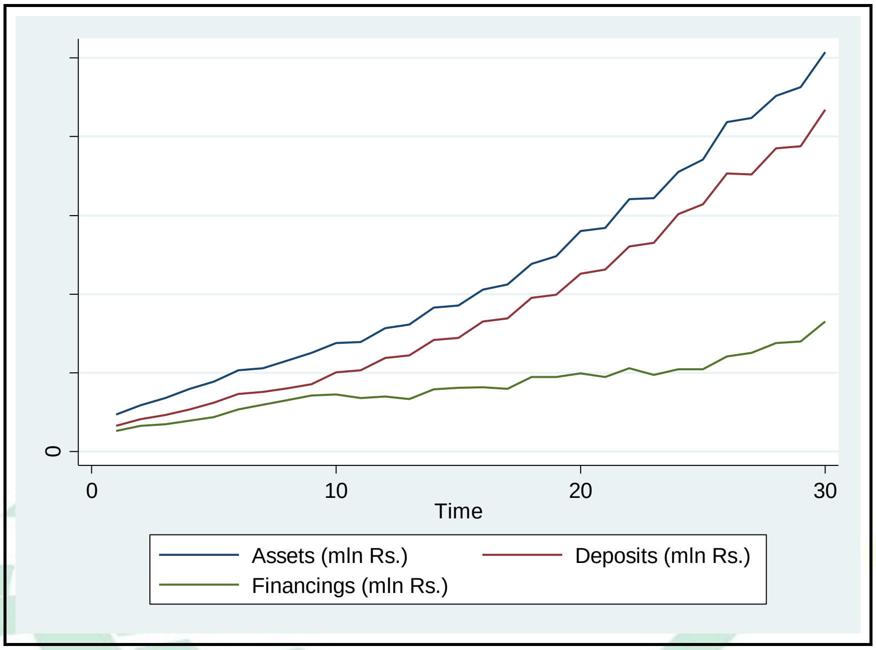
This pool of assets is used to provide asset backed financing. These financing assets are based on different underlying financing contracts, i.e. Ijarah, Diminishing Musharakah, Murabaha, Istisna etc. Islamic bank does not lend money. It provides asset backed financing in which the asset is owned by the bank. These financing modes can be categorized as lease based financing or credit sale based financing. Income stream is generated either through profit on credit sale or rent for the use of asset.

Currently, Islamic banks use the same interbank benchmark rate (KIBOR) in Pakistan for pricing assets in credit sale for profit determination and computing rentals necessary to amortize the cost of asset during lease period.

Income from the sale or lease of real assets is distributed among the contributors in asset pool, including bank's shareholders and depositors. To achieve spreads for financial intermediation function, profit sharing is done between bank and depositors as per the pre-agreed profit sharing ratio.

Figure 1 shows the growth in assets, deposits and advances in Islamic banking industry in Pakistan for the period 2006-13. The exponential and uninterrupted growth is evident from this graph.

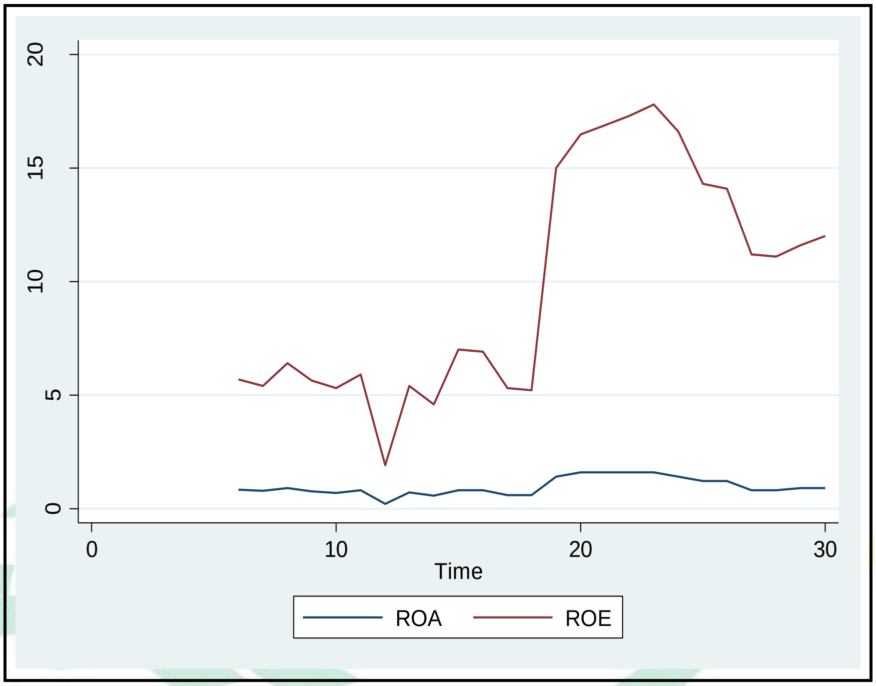
**Figure 1: Growth in Islamic Banking (2006 – 2013)**




**Source: SBP Islamic Banking Bulletin, Various Issues**

Figure 2 shows the profitability in Islamic banking during the period 2007-13 in Pakistan as measured by the accounting ratio, Return on Equity (ROE) and Return on Assets (ROA). It can be seen that initially some banks took time to consolidate and reach breakeven, but in later periods, they have registered strong growth with ROE reaching even 18% and sustaining to be in double digits despite the security, energy and fiscal crisis in the country.

**Figure 2: Profitability in Islamic Banking (2006-2013)**




**Source: SBP Islamic Banking Bulletin, Various Issues**

## Descriptive Analysis of Full-Fledged Islamic Banks

In this section, using annual data for the period 2007-12 from the published financial statements of five full-fledged Islamic banks, we present various stylized facts that emerge from the data. Five full-fledged Islamic banks taken for this study include: Meezan Bank Limited (MBL), Bank Islami (BI), Dubai Islamic Bank (DIB), Bank Al-Barakah (BA) and Burj Islamic Bank (BIB).

### Finance to Deposit Ratio

Finance to deposit ratio for most banks has declined during 2007-12. The possible reasons for that include:

a) Rise in markup rates.
b) High cost of doing business, energy crisis, security crisis etc.
c) Lack of product alternatives to provide distress financing other than for purchase of assets. The demand for distress financing is more in a recession.

### Deposits to Total Assets Ratio

Islamic banks have effectively mobilized deposits during the period 2007-12. Here, several possible reasons can be highlighted for strong deposits growth and mobilization.

a) Deposit mobilization has much less contractual frictions than creating a Shari'ah compliant financing asset. In providing finance, it is important that finance is provided for genuine purchase of an asset whose ownership, possession and risk has to be borne by the bank so as to be able to earn any sale premium or rents for the use of asset.

b) When people become aware of Islamic banking and accept its status as Islamic, most people would start using Islamic banking services first by opening bank accounts than by obtaining finance.

c) It is easier for a customer to switch from a conventional bank deposit to Islamic bank deposit than to convert a conventional debt based liability to Islamic financing product.

d) Islamic banks have remained solvent and liquid and hence during and after the consumer-financing bust, people have placed more faith in Islamic banks for parking their surplus funds.

### NPL to Financing Ratio

NPL to finance ratio has increased during the consumer-financing bust, but comparatively, Islamic banks in Pakistan have lower NPLs and cleaner balance sheets as compared to the conventional banks. After 2010, the ratio is decreasing for all banks in the sample. Possible reasons include:

a) Islamic banks do not provide risky financing, i.e. unsecured loans in Pakistan.

b) Financing is always provided for the purchase of an asset whose ownership belongs to the bank.

c) Since Islamic banks can not earn profit on late payments, they only provide financing to sound clients than creating subprime financing assets.

### Expense to Net Markup Margin Ratio

This ratio has remained high and it shows that Islamic banks have not achieved scale efficiency yet, but the ratio is declining for some banks and stabilizing for some other banks showing a possible reversal. Hike in this ratio could be attributed to:

a) Scale inefficiency.

b) Diseconomies of scale and scope. Each financing contract requires thorough documentation and ascertainment of genuine purchase of an asset.

c) Lack of room to provide every type of loan, like credit cards, running finance, personal finance, travel finance, education finance, health finance etc.

## Net Income to Financing Ratio

Most Islamic banks in Pakistan had been in losses in their initial years of establishment. This is understandable given the heavy capital expenditure required to set up a bank. Secondly, being a small part of the overall market along with increase in the number of players in the banking sector of Pakistan during 90s and 2000s, Islamic banks at the moment cannot use price skimming to break even quickly. However, all banks taken in the sample currently are now in profits.

## NPL to Net Markup Margin Ratio

NPL to markup margin ratio has increased during the consumer-financing bust, but, comparatively, Islamic banks have lower NPLs as compared to conventional banks due to asset backed financing. After 2010, the ratio is decreasing for all banks in the sample. Possible reasons are the same which have been discussed earlier for NPLs to finance ratio.

## Net Income to Total Assets Ratio

Most banks had been in losses in their initial years of establishment. However, all banks in the sample currently are now in profits. The top two banks have had much stable path for this ratio during the period as compared to the new entrants. This shows that there is considerable first mover advantage in Pakistan's Islamic banking sector.

## Challenges for Islamic Banks in Future

Deposit mobilization had been much easier in Islamic banking in Pakistan as compared to using the deposits to provide finance. Islamic banks with assets backed financial products rely much more on formal documented manufacturing based industries where finance is required for plant and machinery, raw material and industrial equipment.

On the other hand, the financing operations that are overly dependent on asset backed debt based modes of financing create several issues.

First, in times of recession, Islamic banks in Pakistan have limited product range for firms that require finance in already ongoing projects in which lumpy investments had been made, but financing is required to meet rising variables costs of energy and utility expense.

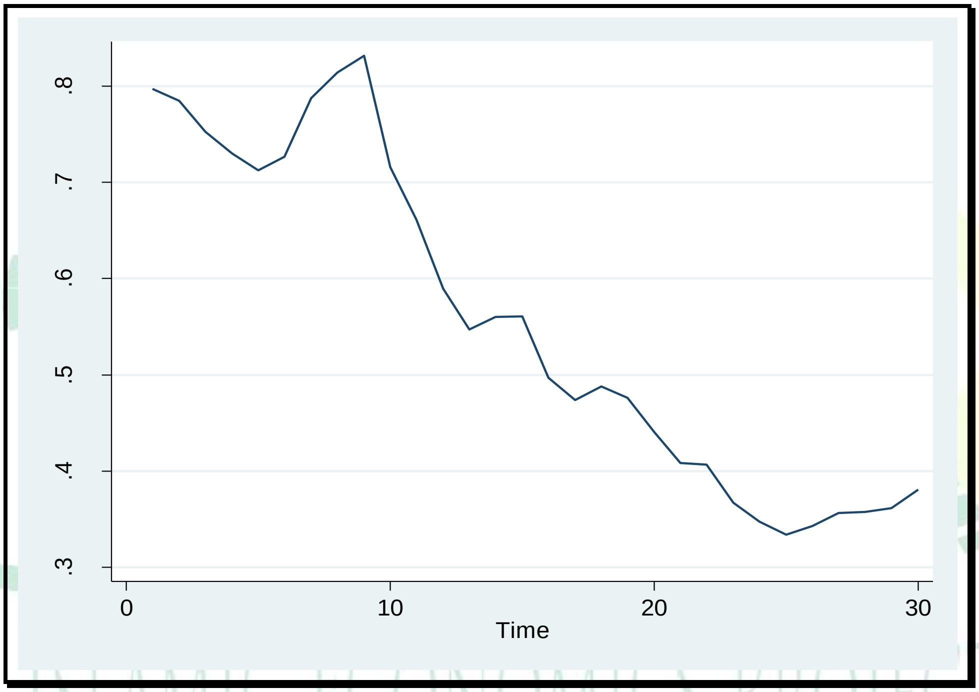
Secondly, in recession, purchasing new assets for expansion is not the first things most firms would do or can afford to do. Hence, if Islamic banks remain stuck in debt based modes of financing, they will have to start offering buyback or sale and leaseback type of products which are not preferable or ideal from the Maqasid-e-Shari'ah perspective.

Third, over-reliance on debt based modes of financing requires firms to take initiative and increase their demand for such products from Islamic banking. Hence, the supply side response by Islamic banks is

hindered and they may remain ineffective in bringing an economy out of recession by providing less restricted and flexible modes of financing like Mudarabah and Musharakah.

Currently, Islamic banks in Pakistan seem to be content with surplus liquidity. Instead of using the deposits by providing finance, they had increased investments. Figure 3 shows the steeply declining Finance to Deposit (FIN to DEP) ratio in Islamic banking in Pakistan during the period 2006-13. This undermines their function of financial intermediation between firms and households.

**Figure 3: Finance to Deposit Ratio (2006-2013)**

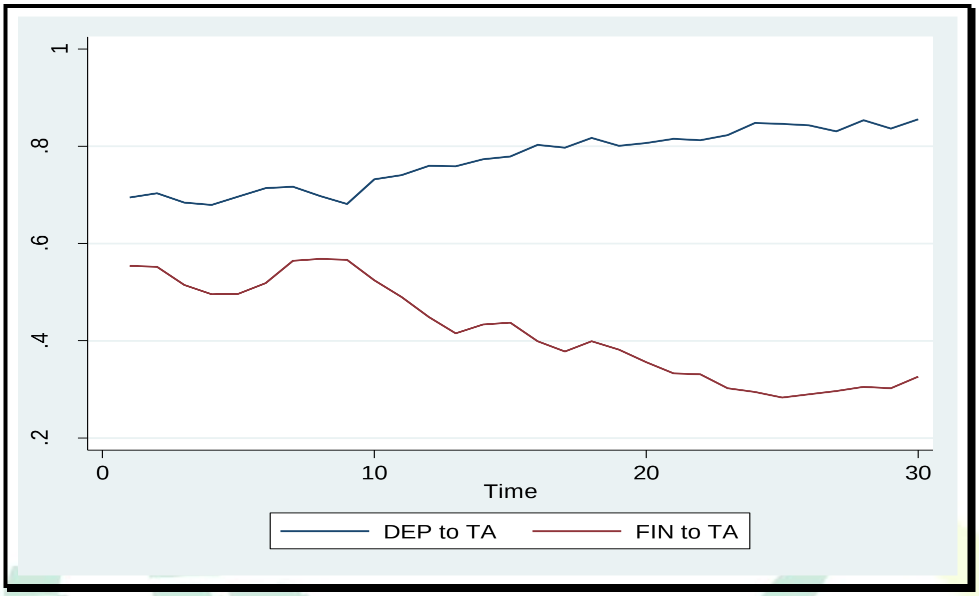



**Source: SBP Islamic Banking Bulletin, Various Issues**

With surplus liquidity at their disposal, Islamic banks could have provided financing using preferable equity modes to facilitate new IPOs in the market and hence encourage equity financing to be used in the economy.

It can be seen in the figure below that the gap between Deposits to Total Assets (DEP to TA) and Financing to Total Assets (FIN to TA) had swelled in recent quarters in Pakistan. It shows that deposit mobilization had been much easier in Islamic banking as compared to using the deposits to provide finance. This widening gap is after the consumer financing credit crunch and can partly be explained by increased intensity of energy crisis which hit the manufacturing sector the most in Pakistan. Islamic banks with assets backed financial products rely much more on formal documented manufacturing based industries where finance is required for plant and machinery, raw material and industrial equipment.

**Figure 4: Finance to Total Assets and Deposits to Total Assets Ratio (2006-2013)**




**Source: SBP Islamic Banking Bulletin, Various Issues**



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